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ARIZONA CORPORATION COMMISSION

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2003 MAR 11 P 4:53

DATE: March 11, 2003

DOCKET NO: E-01345A-02-0707

TO ALL PARTIES:

AZ CORP COMMISSION
DOCUMENT CONTROL

Enclosed please find the recommendation of Administrative Law Judge Lyn Farmer. The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA PUBLIC SERVICE COMPANY
(FINANCING)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00 p.m.** on or before:

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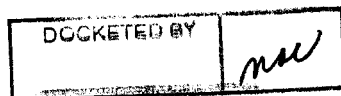
The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the **Special Open Meeting** to be held on:

MARCH 27, 2003

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.

Arizona Corporation Commission
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MAR 11 2003


BRIAN C. MCNEIL
EXECUTIVE SECRETARY

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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MARC SPITZER, Chairman
4 JIM IRVIN
5 WILLIAM A. MUNDELL
6 JEFF HATCH-MILLER
7 MIKE GLEASON

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA PUBLIC SERVICE COMPANY FOR
10 AN ORDER OR ORDERS AUTHORIZING IT TO
11 ISSUE, INCUR, OR ASSUME EVIDENCES OF
LONG-TERM INDEBTEDNESS; TO ACQUIRE A
FINANCIAL INTEREST OR INTERESTS IN AN
AFFILIATE OR AFFILIATES; TO LEND MONEY
TO AN AFFILIATE OR AFFILIATES; AND TO
GUARANTEE THE OBLIGATIONS OF AN
AFFILIATE OR AFFILIATES.

DOCKET NO. E-01345A-02-0707

DECISION NO. _____

OPINION AND ORDER

12 DATES OF HEARINGS:

September 24, 2002 (procedural conference); October 4,
2002 (procedural conference); January 3, 2003 (pre-
hearing); January 8, 9, 10, 13, and 14, 2003

14 PLACE OF HEARINGS:

Phoenix, Arizona

15 ADMINISTRATIVE LAW JUDGE:

Lyn Farmer

16 IN ATTENDANCE:

William A. Mundell, Chairman
Marc Spitzer, Commissioner
Jeff Hatch-Miller, Commissioner
Mike Gleason, Commissioner

18 APPEARANCES:

19 Mr. Michael R. Engleman and Mr. Frederick D.
20 Ochsenhirt, DICKSTEIN, SHAPIRO, MORIN &
OSHINSKY, L.L.P., on behalf of Panda Gila River, LP:

21 Mr. Scott S. Wakefield, Chief Counsel, on behalf of the
Residential Utility Consumer Office;

22 Mr. Thomas L. Mumaw and Ms. Karilee Ramaley,
23 PINNACLE WEST CAPITAL CORPORATION; and
24 Mr. Jeffrey B. Guldner, SNELL & WILMER, P.L.C., on
behalf of Arizona Public Service Company;

25 Mr. James McGuire, ROSHKA, HEYMAN &
26 DeWULF, P.L.C., on behalf of Tucson Electric Power
Company;

27 Mr. Lawrence V. Robertson, Sr., MUNGER
28 CHADWICK, P.L.C.; and Mr. Theodore E. Roberts,
SEMPRA ENERGY, on behalf of Sempra Energy
Resources and Southwestern Power Group, II;

1 Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C.,
2 on behalf of Reliant Energy Resources;

3 Mr. Walter W. Meek, President, on behalf of the
4 Arizona Utility Investors Association;

5 Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on
6 behalf of the Arizonans for Electric Choice and
7 Competition;

8 Mr. Jay I. Moyes, MOYES STOREY, on behalf of PPL
9 Southwest Generating Holdings, LLC; PPL EnergyPlus,
10 LLC; and PPL Sundance Energy, LLC; and

11 Mr. Christopher C. Kempley, Chief Counsel, and Ms.
12 Janet F. Wagner, Staff Attorney, Legal Division, on
13 behalf of the Utilities Division of the Arizona
14 Corporation Commission.

15 **BY THE COMMISSION:**

16 On September 16, 2002, Arizona Public Service Company ("APS" or "Company") filed with
17 Corporation Commission ("Commission") the above-captioned application for financing approval
18 ("Application").

19 On September 20, 2002, Panda Gila River, L.P. ("Panda") filed a Motion for Leave to
20 Intervene. On September 23, 2002, the Residential Utility Consumer Office ("RUCO") filed an
21 Application to Intervene.

22 By Procedural Order issued September 23, 2002, a Procedural Conference was held on
23 September 24, 2002, to discuss the procedures for processing this application. By Procedural Order
24 issued September 25, 2002, a second Procedural Conference was scheduled.

25 On October 4, 2002, the second Procedural Conference was held as scheduled and established
26 procedural dates for the preparation and conduct of this matter and to consider the Motions to
27 Intervene by Panda; Reliant Resources, Inc. ("Reliant"); the Harquahala Generating Company, LLC
28 ("Harquahala"); PPL Southwest Generation Holdings, LLC; PPL Energy Plus, LLC; and PPL
Sundance Energy, LLC (collectively "PPL entities"); the Arizona Utility Investors Association, Inc.
("AUIA"); Southwestern Power Group II, LLC and Bowie Power Station (collectively
"SWPG/Bowie"); Sempra Energy Resources ("Sempra"); Arizona Competitive Power Alliance
("ACPA"); and Tucson Electric Power Company ("TEP").

1 At the Procedural Conference, oral arguments were heard on the motions to intervene and the
2 parties discussed their proposed procedural schedule for this matter. The motions to intervene were
3 granted, and it was noted that the scope of the hearing would not be broadened by their participation.

4 By Procedural Order issued October 9, 2002, the hearing was set to commence on January 8,
5 2003. On October 10, 2002, APS filed an Emergency Motion to Modify the October 9, 2002
6 Procedural Order, and on October 15, 2002, the Commission's Utilities Division Staff ("Staff"),
7 RUCO, and Panda responded to APS' Motion.

8 On October 16, 2002, APS filed a Motion for Protective Order ("Motion"). On October 21,
9 2002, Staff filed its Response; on October 23, 2002, RUCO filed its Response; on October 23, 2002,
10 APS filed its Reply; and on October 29, 2002, Panda filed a Response to Staff's Response. On
11 November 25, 2002, APS withdrew its Motion without prejudice.

12 Notice of the hearing was published in the *Arizona Republic*, the *Bisbee Daily Review*, the
13 *Casa Grande Dispatch*, the *Arizona Daily Sun* (Flagstaff), the *Prescott Courier*, and the *Yuma Daily*
14 *Sun*.

15 The hearing commenced as scheduled in January 8, 2003 and witnesses for APS, AUIA,
16 Panda, RUCO, and Staff testified and presented evidence during five days of hearing. Initial post-
17 hearing briefs were filed on January 27, 2003 and reply briefs were filed on February 6, 2003.

18 BACKGROUND

19 On May 20, 1994, the Commission opened Docket No. U-0000-94-165 to investigate the
20 introduction of retail electric competition. On December 26, 1996, the Commission issued Decision
21 No. 59943, which adopted A.A.C. R14-2-1601 through 1616, the Retail Electric Competition Rules.
22 Hearings were held on generic stranded cost issues, and on June 28, 1998, the Commission issued
23 Decision No. 60977 on Stranded Costs. On August 10, 1998, in Decision No. 61071, the
24 Commission adopted amended rules on an emergency basis, and on December 11, 1998, adopted the
25 emergency rules on a permanent basis in Decision No. 61272. On January 11, 1999, the Commission
26 issued Decision No. 61311, which stayed the Retail Electric Competition Rules and related decisions,
27 including Decision No. 60977.
28

On April 27, 1999, the Commission issued Decision No. 61677, which amended Decision No. 60977, the Commission's prior Stranded Cost decision. Decision No. 61677 ordered the Hearing Division to issue a Procedural Order to set dates for consideration of stranded costs and unbundled tariffs for each Affected Utility. The revised Retail Electric Competition Rules were published on May 14, 1999 and public comment sessions were held. On May 18, 1999, APS filed for approval of a Settlement Agreement, a hearing was held, and the Commission issued Decision No. 61973 (October 6, 1999), approving the Settlement Agreement with changes. On September 29, 1999, the Commission issued Decision No. 61969, which approved the revised Retail Electric Competition Rules ("Electric Competition Rules"). In Decision No. 62924 (October 10, 2000) the Commission adopted clarifying revisions to the Electric Competition Rules.

The Settlement Agreement provided and Decision No. 61973 granted a two-year extension of time, until December 31, 2002, for APS to separate assets (A.A.C. 1615(A)¹) and also granted a "similar two-year extension" for compliance with A.A.C. R14-2-1606(B)². APS planned to divest its competitive generation assets to a yet-to-be formed generation affiliate. The Addendum to APS' Settlement Agreement also provided that: "[a]fter the extensions granted in Section 4.1 have expired, APS shall procure generation for Standard Offer customers from the competitive market as provided for in the Electric Competition Rules. An affiliated generation company formed pursuant to this Section 4.1 may competitively bid for APS' Standard Offer load, but enjoys no automatic privilege outside of the market bid on account of its affiliation with APS." (4.1(3))

On October 18, 2001, APS filed a Variance/Purchased Power Agreement ("PPA") application. The application stated that "adherence to the competitive bidding requirements of the Electric Competition Rules will not produce the intended result of reliable electric service for Standard Offer customers at reasonable rates," requested that the Commission grant a partial variance to R14-2-1606(B) that would otherwise obligate APS to acquire all of its customers' Standard Offer generation requirements from the competitive market, and sought Commission approval of a long-term purchase power agreement with its parent, Pinnacle West Capital Corporation ("PWCC").

¹ A.A.C. R14-2-1615(A) provides: "All competitive generation assets and competitive services shall be separated from an Affected Utility prior to January 1, 2001. Such separation shall either be to an unaffiliated party or to a separate corporate affiliate or affiliates. If an Affected Utility chooses to transfer its competitive generation assets or competitive services to a competitive electric affiliate, such transfer shall be at a value determined by the Commission to be fair and reasonable." ("Rule 1615(A)")

² A.A.C. R14-2-1606(B) provides: "After January 1, 2001, power purchased by an investor owned Utility Distribution Company for Standard Offer Service shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process." ("Rule 1606(B)")

By Procedural Order issued on May 2, 2002, a generic proceeding was established that set up Track A to resolve issues relating to market power, divestiture, codes of conduct/affiliate transactions and jurisdictional issues. It also established Track B to address competitive procurement. On September 10, 2002, the Commission issued Decision No. 65154 in the Track A proceeding. On September 16, 2002, APS filed this application. On November 8, 2002, APS filed an "Emergency Application" requesting a partial waiver of A.A.C. R14-2-804(B)(1) and (2) to allow APS to make short-term advances to PWCC in the form of an inter-affiliate line of credit, or alternatively, in the form of an APS guarantee of PWCC's short-term debt. In Decision No. 65434 (December 3, 2002), the Commission granted the request with conditions. On March __ 2003, the Commission issued its Decision No. _____ in Track B.

DISCUSSION

APS' parent, PWCC, has incurred approximately \$1 billion in debt in order to finance the construction of generating units³ at Pinnacle West Energy Corporation ("PWEC"), its merchant subsidiary. PWCC used debt with short-term maturities⁴ because it planned for PWEC to refinance the debt at an investment grade once the APS rate-based generation assets were transferred to PWEC. In Decision No. 65154 (September 10, 2002), the Commission ordered APS to cancel any plans to divest interests in any generating assets.⁵ On September 16, 2002, APS filed this financing application. APS, on behalf of its parent and affiliate, claims that without the APS generation assets, PWEC does not have an investment grade credit rating and therefore cannot finance the PWEC generation assets. Further, APS claims on behalf of its parent and affiliate, that due to market conditions, PWEC cannot obtain project financing. PWCC's bridge debt begins coming due in August 2003.

In its application APS asks that the Commission:

- Authorize the Company to assume, issue, or incur up to \$500,000,000 in aggregate principal amount of Recapitalization Debt;
- Authorize the Company to determine the terms associated with the Recapitalization Debt, including whether any portion of the Recapitalization Debt will be secured by

³ West Phoenix combined cycle generating units 4 & 5, Saguaro combustion turbine Unit No. 3 and Redhawk Units 1 & 2.

⁴ This has been referred to as PWCC's "bridge debt".

⁵ The Decision also provided that if "APS wishes to pursue the issue of acquiring PWEC's generation assets, it shall file the appropriate application(s) by September 15, 2002."

all or a portion of the Company's assets;

- Authorize the Company to provide the APS Guarantees in accordance with the Application;
- Authorize the Company to determine the terms associated with the APS Guarantees, including whether any portion of the APS Guarantees will be secured by all or a portion of the Company's assets;
- Provide that the Recapitalization Debt and the APS Guarantees will not be classified or counted as Continuing Debt;
- Find that the issuance and incurrence of Recapitalization Debt, and the issuance of the APS Guarantees are reasonable necessary or appropriate for the purposes set forth in this Application and that such purposes are within those permitted by A.R.S. § 40-301, *et seq.*;
- Permit such purposes to the extent they may be reasonably chargeable to operative expenses or to income and allow the payment of related expenses as contemplated herein;
- Authorize APS to obtain a financial interest in PWEC or Pinnacle West in the form of an inter-affiliate loan, APS Guarantees, or a combination of the two up to a maximum aggregate principal amount of \$500,000,000;
- Authorize APS to make such expenditures, sign and deliver such documents, and negotiate such terms and conditions with underwriters or selling agents, purchasers and/or lenders, including but not limited to those pertaining to terms, rates, and collateral requirements (if any), all as described herein, as may be reasonably necessary to economically effectuate the other authorizations granted herein; and
- Grant the Company such additional relief as is appropriate under the circumstances.

The Company is requesting approval of either an inter-company loan, a guarantee, or a combination of both. The proceeds of the long-term debt incurred by APS would then be loaned to either PWEC or PWCC. The funds would be used to pay off an equivalent amount of PWCC debt previously incurred to finance construction of the PWEC assets.

Jack Davis, APS President and CEO, and PWCC President, testified that the following were benefits from granting the application: avoiding a downgrade of APS debt ratings; avoiding corresponding increases in the APS cost of capital; strengthening wholesale competition by maintaining PWEC as a viable competitor in the upcoming Track B solicitation; preserving the Commission's ability to consider rate base treatment of the PWEC assets in the 2003-2004 rate case; strengthening investor and rating agency confidence in the Commission; continuing a responsive and responsible regulatory environment; preserving the current Track B solicitation process; and resulting in settlement of most of the issues in the Track A legal appeals. (APS-8 at 4-5) Further, in its Initial

1 Post-Hearing Brief, APS identified what it believes are additional benefits to it and its customers
2 from approval of the application, including net interest income of between 7.5 to 13.2 million dollars
3 per year, and with Staff conditions, there may be greater regulatory insulation for APS within the
4 holding company structure.

5 APS witness, Arthur Tildesley, Managing Director, Salomon Smith Barney, Inc., testified that
6 under current market conditions, PWEC would be unable to raise significant debt financing on a
7 standalone or non-recourse basis. "Without the transfer of the APS generation assets or the
8 establishment of some form of power purchase agreement ("PPA"), the business profile and credit
9 quality of PWEC would be viewed as very weak." Mr. Tildesley testified that "APS business
10 fundamentals and credit statistics are strong, and we believe that APS has significant capacity to
11 provide an intercompany loan or guarantee to PWEC in the amount of \$500 million without
12 impairing fundamental utility credit quality." Mr. Tildesley did not attempt to evaluate PWEC's
13 ability to actually service the loan, and in fact, for purposes of determining the impact of a loan on
14 APS, he assumed no repayment capacity at PWEC. (APS-3 pp 4 & 5)

15 **AUIA**

16 The AUIA urged the Commission to grant APS the authority it seeks and believes that this
17 action would be in the public interest in safeguarding the financial integrity of APS and its parent.
18 AUIA believes that if APS' credit cannot be used, "it is not inconceivable that a bankruptcy and/or a
19 forced sale of some or all of the PWEC assets could occur. Of course, any sale in the near future
20 would be into a market that is already glutted with the bad construction decisions of merchant
21 generators." (AUIA-1 at 5). AUIA believes that such an impact on APS would not be positive as it is
22 "increasingly difficult to insulate an affiliate from the fortunes of its holding company and vice versa
23 and it is unrealistic to expect that APS would be immune from a financial meltdown at Pinnacle
24 West." (Id.)

25 **Staff**

26 Staff believes that APS could face a downgrade if PWCC is downgraded, that such a
27 downgrade of APS could interfere with APS' ability to provide electric service to the public if it
28 resulted in increases in the cost of capital, potential lack of access to the capital markets, potential

1 increases in collateral requirements, and an inability to do business with vendors. Staff believes that
2 APS' requested financing will be compatible with the public interest if, by preventing a downgrade in
3 APS' credit ratings, it prevents a substantial disintegration in APS' ability to provide service. For
4 those reasons, Staff recommended that the Commission authorize APS to borrow \$500 million in
5 order to loan the proceeds to PWEC.

6 Although Staff concludes that APS' proposed financing will likely serve the public interest,
7 Staff believes that the transaction poses some risks to the Company and to its ratepayers, including
8 the fact that issuing debt to loan to PWEC will diminish APS' ability to obtain its own required debt
9 capital needed in the coming years, and that the proposed financing runs counter to the goal of
10 insulating APS from its affiliates' unregulated activities. Staff believes that these considerations do
11 not outweigh the need to prevent a downgrade to APS' credit rating, but require conditions to
12 approval of the financing. Staff Conditions for approval include:

- 13
- 14 1. APS should be authorized to issue and sell no more than \$500,000,000 of debt in
addition to its current authorizations;
- 15 2. The debt to be lent to PWEC should be no more than \$500,000,000 of secured callable
notes from PWEC. The security interest shall be on the same terms as the security
16 interest APS already has pursuant to the \$125,000,000 loan authorization from
Decision No. 65434;
- 17 3. The PWEC secured note coupon shall be 264 basis points above the coupon on APS
debt issued and sold on equivalent terms (including but not limited to maturity and
18 security);
- 19 4. The difference in interest income and interest expense should be capitalized as a
deferred credit and used to offset rates in the future. The deferred credit balance shall
20 bear an interest rate of six percent;
- 21 5. The PWEC debt maturity shall not exceed four years, unless otherwise ordered by the
Commission;
- 22 6. Any demonstrable increase in APS' cost of capital as a result of the transaction, such
as from a decline in bond rating, will be extracted from future rate cases; and
- 23 7. APS shall maintain a minimum common equity of 40 percent and shall not be allowed
to pay dividends if such payment would reduce its common equity ratio below this
24 threshold, unless otherwise waived by the Commission. The Commission will process
the waiver within sixty days, and for this sixty-day, period this condition shall be
25 suspended. However, this condition shall not be permanently waived without an order
of the Commission. During the hearing, Staff proposed two clarifications to Condition
26 7: that the condition should remain in effect indefinitely and that APS should file the
capital structure calculation with the Commission within one week of filing a 10-Q or
27 10-K.
- 28

1 Staff's conditions 2 and 6 are designed to protect APS and its ratepayers from any harm that
2 may result from this transaction. Condition 2 is necessary to ensure that APS' interests are protected
3 if there were a default on the loan. Condition 6 puts the Company and its affiliates on notice that any
4 negative credit effects to APS will not be borne by its ratepayers. Conditions 3 and 4 are designed to
5 ensure that APS and its ratepayers are appropriately compensated for the risk associated with the
6 transaction. Conditions 5 and 7 are intended to provide appropriate regulatory insulation between
7 APS and its affiliates.

8 Staff believes that ordinarily, it would probably recommend denial of such a financing.
9 However, Staff believes that the circumstances surrounding this application are "far from ordinary"
10 "The financial markets are deteriorating, the energy sector is in disarray, electric utilities in
11 neighboring states have suffered financial difficulties, and the wholesale market for electricity has
12 been volatile. Against this backdrop, the Commission's policy should be aimed at ensuring that
13 Arizona will continue to have financially sound electric utilities. Because of the potential risk of a
14 downgrade to APS' credit rating, the Commission should approve APS' application; because of the
15 potential risks inherent in this transaction, the Commission should condition its approval upon Staff's
16 seven conditions." (Staff Initial Br. At 6).

17 Staff asserts that the Commission should not base its approval of this application upon APS'
18 allegations that the Commission is at fault for PWCC's predicament. Staff states that throughout its
19 presentation of its case, "APS has implied that the Commission is responsible for PWCC's dilemma,
20 claiming that the Commission 'largely created' this problem 'in the first instance.' (Ex. APS-1 at 24).
21 Over and over again, APS insinuates that the Commission's Track A order is largely to blame, (APS'
22 Br. At 5, 7), and that the Commission is now responsible for repairing that order's 'loose ends.' (Tr.
23 at 586). Finally, APS has stated that incurring the bridge debt was 'consistent with Commission
24 guidance and directives,' (APS' Br. At 8), as if the Commission were the entity that decided to build
25 the PWEC assets and to finance them through short term bridge debt. The Commission should not
26 conclude that it is responsible for PWCC's problems, and it certainly should not base its approval of
27 this application upon such claims." (Staff Reply Br. at 5).

28 Staff cites the existing turmoil in the financial markets and the volatility that has existed in the

1 wholesale electric market. Staff's witness testified that if the Commission had not stopped
2 divestiture, given the current market situation, PWEC could have been facing an even worse problem
3 than trying to finance now. Staff further noted that the "PWCC enterprise chose to build the assets at
4 PWEC, chose to finance them at the holding company level, and chose the maturities of the debt.
5 None of these decisions were made or sanctioned by the Commission. APS will argue that its code of
6 conduct prevented it from building the PWEC assets at APS (Tr. at 520); nonetheless, an examination
7 of that document does not clearly support that conclusion." (Staff Reply Brief at 5-6)

8 **RUCO**

9 RUCO recommends granting the financing application and also proposes that APS be
10 required to file an application with the Commission within 45 days to transfer the PWEC generation
11 assets to APS.

12 RUCO believes that because APS will use borrowed funds to protect its own credit rating, the
13 financing is within the proper performance of its duties as a public service corporation. Based upon
14 Moody's December 30, 2002 Opinion Update on APS and Standard and Poor's statement that
15 "[e]ven on a stand-alone basis, APS' financial health remains solidly within the 'BBB' category even
16 with the addition of \$500 million in debt" (Ex S-4), RUCO believes that the financing will not impair
17 APS' ability to perform its public service obligations.

18 RUCO believes that with conditions, the financing is compatible with the public interest.
19 According to RUCO, it will allow PWEC/APS to maintain the generation assets to the benefit of APS
20 customers. RUCO notes that generally, a utility issuing debt to finance assets owned by an affiliate is
21 not compatible with sound financial practices, however, RUCO believes that it and Staff have
22 proposed conditions that would make the financing consistent with sound financial practices. RUCO
23 recognizes that "[t]ransferring the PWEC assets to APS and including some or all in rate base could
24 signal the death knell for wholesale competition", however, RUCO argues that "it is in the public
25 interest for the Commission to take action to protect the public, even if that means returning to an
26 integrated electric utility model at this time." (RUCO Reply Br. at 3) RUCO concludes that granting
27 the APS application is "merely a stopgap measure to prevent PWCC from defaulting on its short-term
28 debt obligations and going into bankruptcy" and that a "cohesive comprehensive plan to rebuild the

1 regulatory paradigm is necessary to return the electric industry in Arizona to functional viability.”
2 (RUCO Br. At 7)

3 **Panda**

4 Panda recommends that the Commission deny the financing application, but if it does approve
5 some form of credit support to an affiliate, that the Commission require that it be in the form of a
6 guarantee of affiliate debt, but not a direct inter-company loan. Panda disagrees with APS’ assertions
7 that PWCC cannot refinance the debt itself; that PWCC will be downgraded if the financing
8 application is denied; that APS will be downgraded if the financing application is denied; and that if
9 the financing is approved, APS will not be harmed, even with the Staff conditions.

10 According to Panda, APS asserted two primary reasons for Commission approval of the
11 financing. First, APS argues that the Commission’s decision in the Track A harmed it and its parent
12 and affiliate, and that the Commission should approve the financing as a remedy. Second, APS
13 argues that PWCC is fundamentally different from other merchant generators and therefore,
14 Commission should protect it.

15 Susan Abbott, a former Moody’s analyst with twenty years experience rating utility
16 companies, including APS, testified on behalf of Panda.

17 Panda argues that there is no evidence in the record that PWCC will suffer a downgrade if
18 APS does not refinance the bridge debt. In its Initial Brief, Panda states “APS introduced *no* written
19 evidence that PWCC would be downgraded if it refinanced or renegotiated the bridge debt at the
20 holding company level, nor any evidence that such a refinancing or renegotiation is impossible.
21 Rather, Ms. Gomez relied on undocumented and unsubstantiated conversations she allegedly had
22 with lenders and rating agency personnel during the course of which, or even after which, she failed
23 to take a single note. Tr. at 114, lines 3-6 . . . In short, Ms. Gomez could produce no evidence to back
24 up her assertion that PWCC would be downgraded if it refinanced the bridge debt at the holding
25 company level.” (emphasis original) (Panda Initial Br. p. 11) Panda’s witness testified that were she
26 analyzing PWCC, she would not recommend a rating downgrade if PWCC refinanced the debt,
27 because PWCC’s credit metrics would remain within the BBB range. Ms. Abbott further noted that
28 APS testified that PWCC could raise \$300 million over the next year for its Nevada generation

1 (Silverhawk).

2 Panda also argues that there is no evidence in the record that APS will suffer a downgrade if
3 PWCC is downgraded. Panda's witness testified that a downgrade of a holding company can result
4 in a downgrade of the utility subsidiary when the parent's debt load is so high as to require
5 substantial dividends from the utility company in order for the parent to service the debt, but here, the
6 debt load of the parent would not change, since it is a refinancing. Panda argues that any evidence
7 that APS will not be downgraded if it assumes an additional \$500 million in debt is "either not
8 credible or is entirely self-serving." (Initial Br. at 14) Panda's witness testified that the analysis of the
9 rating agencies depends on what information was provided by the utility, and Panda argues that since
10 APS sent its testimony (which says APS intends to seek rate base treatment of the PWEC generation
11 assets) to the rating agencies but APS' witness cannot remember what she told the rating agencies,
12 there is no way to know whether the analyses presume rate base treatment of the PWEC assets, and
13 therefore would decline if the assets did not become rate based. Panda also argues that the relevance
14 of prior rating agency statements are questionable "given that APS appears to have provided
15 inaccurate information to the rating agencies and analysts in the past as well. Shortly after the 1999
16 Settlement and after PWEC proposed constructing generation assets, APS and PWEC told the rating
17 agencies that PWEC and APS either had, or would, enter into a four-year Power Purchase Agreement
18 ("PPA") for the supply of APS' power requirements, even though the final two years of the PPA
19 would be *after* the date when APS was required to procure 100% of its Standard Offer Service
20 requirements from the competitive market rather than from its unregulated merchant affiliate. Exhs.
21 P-23, 24 and 25. On cross-examination, Ms. Gomez admitted that there really was no such PPA, and
22 that APS merely told the rating agencies that it 'expected' to sell power under just such a contract. Tr.
23 at 145-146. The documents offer no such qualification, and it is reasonable to infer, therefore, that
24 had the agencies been provided more accurate information, they likely would not have opined as they
25 did." (Panda Initial Br. at 14-15)

26 Ms. Abbott testified that if additional leverage were to be placed on APS, it is difficult to
27 believe that would not be reflected in a ratings downgrade by Moody's and Fitch, and by S&P at the
28 first mortgage bond level. She found that APS' financial parameters would decline significantly, and

1 although they are not the only concern for the rating agencies, they are important guideposts that have
 2 a heavy influence on ratings. Panda argued that even if APS is not downgraded as result of making a
 3 loan to its affiliate, its credit quality will suffer. Ms. Abbott testified that approval of the financing
 4 application would diminish APS' credit quality and that she would have not recommended keeping
 5 the rating the same based on her analysis and conclusion that the resulting financial metrics were
 6 more commensurate with those of other vertically integrated fully regulated utilities in the "B11"
 7 range. (Tr. at 752) She expressed some surprise at Moody's December 30, 2002 statement, indicating
 8 that although ratings are not the sole product of financial metrics, it is not known what information
 9 APS provided to Moody's. APS Treasurer, Ms. Gomez testified that she did not keep records of her
 10 conversations.⁶

11 Another concern expressed by Ms. Abbott is that a loan or guarantee between APS and
 12 PWCC would make that relationship closer, and APS will be less protected from negative
 13 circumstances affecting PWCC. She concludes that there are negative consequences to APS
 14 ratepayers in the long run, including higher interest costs should APS be downgraded, and a less
 15 robust competitive market in Arizona leading to higher purchased power costs. Panda believes that
 16 the appropriate place to refinance the PWEC assets is at PWCC.

17 Panda cites the rulemaking docket and order that adopted the Public Utility Holding
 18 Companies and Affiliated Interests Rules A.A.C. R14-2-401 *et seq.* ("Affiliated Interest Rules") to
 19 support its position that the application should not be granted. Panda quotes the Commission's
 20 Concise Explanatory Statement:

21 The Rules were first promulgated in 1985 in response to the formation [of PWCC
 22 by APS] and to its acquisition one year later of MeraBank, a federal savings and
 23 loan institution. The Commission at the time expressed concerns that the
 transactions would prevent proper regulation and effect the establishment of rates
 for APS. In response, APS and its parent offered assurances to the Commission

24 ⁶ Q. I think you responded in response to data requests that, in fact, you have no written statements from any of the
 25 financing agencies; is that correct? As far as your discussions with them?

A. That's right. We don't keep documentation of the discussions with them.

26 Q. Why is that?

A. It's our practice to not keep documentation.

27 Q. Okay. So you keep no documentation of any of your discussions with Moody's, Fitch, Standard & Poor's?

A. No, I don't. The discussions happen frequently and I do not keep records of that.

28 Gomez Tr. pp. 113-114. See also TR. At 117 & 298.

1 that the concerns were unfounded . . . The huge capital losses which have recently
2 been experienced by MeraBank and have forced Pinnacle West to the brink of
3 financial collapse served as the catalyst for the Commission to again engage in
4 rulemaking for the regulation of public utility holding company formation and
5 affiliated transactions . . . Article 8 is designed to ensure that utility ratepayers are
6 insulated from the dangers proven to be inherent in holding company structure and
7 diversification. Its singular purpose is to ensure that ratepayers do not pay rates for
8 utility service that include costs associated with holding company structure,
9 financially beleaguered affiliates, or sweetheart deals with affiliates intended to
10 extract capital from the utility to subsidize non-utility operations.⁷

11 The Concise Explanatory Statement also stated that the Rules were intended to implement
12 these principles: "First, utility funds must not be commingled with non-utility funds. Second, cross-
13 subsidization of non-utility activities by utility ratepayers must be prohibited. Third, the financial
14 credit of the utility must not be affected by non-utility activities. Fourth, the utility and its affiliate
15 must provide the Commission with the information necessary to carry out regulatory
16 responsibilities." (Id.)

17 Panda concludes that "APS's (sic) assertion that APS' credit rating will be adversely affected
18 if it is not permitted to loan half a billion dollars to its non-regulated affiliate is clearly an action that
19 the Affiliated Interest Rules were intended to prohibit." (Panda Initial Br. at 5-6)

20 Panda argues that APS failed to prove the elements required by the statutory and regulatory
21 standards, but instead posed the "eight 'benefits'" it believes the financing provides.

22 Panda argues that the evidence demonstrates that PWEC assets were built to serve the
23 wholesale market, not APS customers. (Panda Initial Brief pp 15-19)

24 Panda believes that if the Commission decides that it is in the public interest for APS to
25 provide some credit support for its affiliate, it should be in the form of a guarantee, and not a loan.

26 Panda recommends that the Commission restrict any financing to an APS guarantee of
27 PWEC's debt because it would: maintain the separation of regulated and unregulated assets; preserve
28 to the greatest extent possible the goal of wholesale competition; not prejudice or call into question
the issue of rate basing PWEC assets; allow PWEC to make an entry into the financial markets⁸; and

⁷ In the Matter of the Notice of Proposed Adoption of Rules for Regulation of Public Utility Companies with Unregulated Affiliates, Decision No. 56844, Attachment B at 2 (1990).

⁸ APS' witness, Arthur Tildesley of Salomon Smith Barney testified that while the guarantee structure "may be perceived by investors as somewhat more complex and may be marginally more expensive than an intercompany loan, it has the benefit of the notes being issued directly by PWEC." (APS-3 at 9)

1 APS credit quality would not suffer as much, because there is no intere obligation on a guarantee⁹.

2 Panda believes that the Commission's goal should be to establish PWEC as a standalone
3 entity as soon as possible, and a direct loan from APS to PWEC would perpetuate the relationship
4 between regulated and unregulated entities, whereas a corporate guarantee would provide more of a
5 degree of separation.

6 Panda argues that APS' new reason to prefer a loan to a guarantee is because the guarantee
7 would be more difficult to undo if the PWEC assets are rate based. Panda states that the
8 "Commission is faced with the choice of using a guarantee, which APS witnesses have testified
9 advances the future potential of PWEC standing on its own two feet, or allowing an inter-company
10 loan, the only benefit of which is that it makes APS' desire to rate base the PWEC assets easier.
11 With these facts and the Commission's objective to preserve a viable competitive wholesale market,
12 it should be an easy choice for the Commission to select the corporate guarantee over the inter-
13 affiliate loan." (Panda Initial Br. at 27) "Putting the PWEC assets in APS' rate base is the antithesis
14 of promoting wholesale competition. As Jack Davis made clear, if the PWEC assets go into rate base
15 they will all but eliminate APS' capacity and energy needs going forward. Tr. at 655 . . . Based on
16 Mr. Davis' testimony, there is little question that rate-basing the PWEC assets would decimate
17 wholesale competition in Arizona. Hence, if approval of the loan option would make this rate-basing
18 any more likely, it should be rejected in favor of the guarantee option." (Panda Initial Br. at pp 28-
19 29).

20 Panda argues that the potential harm to wholesale competition can be created by the loan itself
21 and by a default under the loan. APS has indicated its intent to transfer the PWEC assets to APS and
22 seek rate base treatment, and defaulting on the loan could accomplish that goal. According to Panda,
23 APS' assertions that the potential for cross-defaults would prevent a PWEC default would not suffice,
24 because the PWCC debt that contains cross-defaults will expire, leaving only a \$25 million callable
25 Prudential loan at the end of 2004. Further, even if new debt contains the cross-default provisions,
26 Panda believes that since the cross-default language is discretionary (the lender *may* declare the debt

27
28 ⁹ APS testified that it proposed the guarantee option "because of its potentially reduced impact on APS and because it
might provide PWEC some 'credit exposure' in the market that would be valuable in the future." (APS-2 at 7).

1 to become immediately due and payable) and that such provisions are routinely waived by lenders, a
2 waiver would be expected in an inter-company transaction. Panda also believes that APS' assertion
3 that Deeds of Trust would also prevent automatic transfer to APS upon PWEC default is without
4 merit, as the Deeds of Trust allow APS to 'enter upon and take possession of the trust estate.' Deed of
5 Trust at 9, paragraph 1.10." (Panda Initial Br. at 31). Panda argues that a direct inter-company loan
6 has the potential to adversely affect wholesale competition because APS would have a strong
7 incentive to prefer its affiliate in the Track B competitive solicitation, both to support payment of its
8 loan and to establish a case for rate base treatment of the PWEC assets.

9 Panda also points out that the cost of a guarantee would have been evaluated when APS first
10 proposed that alternative, and states that any costs of pursuing a guarantee would be borne by PWEC
11 and would be of no consequence to APS or its customers.

12 Panda proposes what it believes are three critical terms to any guarantee: the PWEC assets
13 must be pledged as collateral for the loan; the lender must execute on the assets prior to seeking
14 payment from APS; and APS should not be permitted to bid on the assets in the event PWEC were to
15 default and a sale of assets be held.

16 In response to APS' argument that under a guarantee, ratepayers will not have the benefit of
17 the conditions Staff proposes. Panda argues that these are not "benefits" but ways to mitigate harm
18 from the financing. Panda also argues that Staff's conditions only address the rate impacts of an
19 increase in APS' cost of capital, and do not address other ways approval of a loan may harm APS
20 ratepayers. Panda believes that loan approval will directly harm the competitive market by making it
21 much more likely APS will ultimately be able to include the PWEC assets in APS rate base. Staff did
22 not analyze the effect of loan approval on wholesale power rates, and Panda argues that therefore,
23 Staff cannot be certain that approval of the application will not harm APS customers.

24 In response to Staff's assertion that a guarantee is inappropriate, Panda argues that if Staff still
25 believes that a risk premium is appropriate to reflect the risk that APS would be called upon to pay
26 the amount of difference between the underlying PWEC debt and the value of the PWEC assets, the
27 transaction could be structured to collect such a risk premium from PWEC. Panda states that Staff's
28 concern about APS not having a primary security interest is misplaced unless the point of the security

1 interest is that APS ultimately owns the PWEC assets or if Staff believes that the PWEC assets are
2 not worth at least \$500 million. This is because the security interest requirement is to make sure that
3 ratepayers are protected by allowing an opportunity to exercise on the collateral to recover the loan.
4 Under the guarantee, APS would bear no risk of making any payment unless and until PWEC
5 defaults, and only then if the PWEC assets are sold for less than the deficiency amount. As far as
6 Staff's assertion that a guarantee is impractical, Panda notes that it was APS that proposed the
7 guarantee and has consistently agreed to use the guarantee if the Commission determined that it was
8 appropriate; that APS has had time to any prepare and address any additional complexities; and that
9 APS' own lender witness testified that his firm would be interested in placing the guarantee and
10 underlying PWEC debt.

11 **Sempra/SWPG/Bowie**

12 Sempra/SWPG/Bowie believes that the Commission should deny the financing for both
13 policy and failure of proof reasons.

14 Sempra/SWPG/Bowie believes that serious questions exist as to whether APS has
15 satisfactorily discharged its probative burden under A.R.S. § 40-301(C). Sempra/SWPG/Bowie
16 argues that the analysis should look at "whether the proposed borrowing and loaning by APS is for a
17 'lawful purpose' directly related to each of the five (5) decision making standards set forth in A.R.S.
18 § 40-301(C)." (emphasis original)(Reply Br. at 9)

19 Specifically, Sempra/SWPG/Bowie concluded that APS had not met its burden of showing
20 that its proposed financial assistance to its affiliate is within its corporate powers and intended
21 corporate purpose.

22 Sempra/SWPG/Bowie argues that the record contains no credible evidence that APS'
23 creditworthiness or financial integrity would be impaired if the financing were denied.
24 Sempra/SWPG/Bowie state that "[o]n the face of it, the use of its creditworthiness and financial
25 resources by APS to prop up an unregulated generation affiliate, and to financially back-stop its
26 unregulated corporate parent, would appear to have nothing to do with the proper performance of its
27 role and obligations as a public service corporation" (Sempra/SWPG/Bowie Initial Br. at 11), a
28 finding required under A.R.S. § 40-301(C). Sempra/SWPG/Bowie further stated that APS

1 acknowledges that it may be required to secure a loan with mortgage lien on APS assets and argues
2 that “[t]he very existence of such a mortgage lien would, by its very nature, restrict APS’ ability to
3 use its assets to borrow or bond for its own needs from what would otherwise be the case.” (Br. at 12)
4 Sempra/SWPG/Bowie believes that given this uncertainty, APS is unable to show that its ability to
5 properly perform its public service obligations might not be impaired at some future date.

6 Sempra/SWPG/Bowie suggests that when looking at whether the financing is in the public
7 interest, the Commission may consider whether the purposes underlying APS’ proposed borrowing
8 and lending, or guarantee, are consistent with its purpose and responsibilities as a public service
9 corporation and whether there is a risk that the results would be inconsistent with other “public
10 interest” determinations previously made by the Commission. (Sempra/SWPG/Bowie Reply Br. at
11 11)

12 Sempra/SWPG/Bowie argued that it is imperative that this Decision not undercut or dilute the
13 Commission’s efforts to facilitate the development of a viable competitive wholesale electric market
14 through the Track B proceeding or preposition the Commission as to how it may resolve any future
15 APS request to acquire or rate base PWEC’s generation assets.

16 In its Reply Brief, Sempra/SWPG/Bowie argues that APS continues to attribute a potential
17 “liquidity crisis” that threatens its parent’s financial integrity to Decision No. 65154.
18 Sempra/SWPG/Bowie notes that the Track A proceeding was instituted in part in response to APS’
19 Variance/PPA application; that it was APS’ parent, PWCC, that decided how to finance the PWEC
20 assets and chose the maturity dates for such financing; and that there is no suggestion that APS had
21 any role in that decision or that the Commission was consulted. “Rather, it appears PWCC made the
22 decision for its own financial gain, and with a view towards avoiding ‘more expensive and restrictive
23 financing’ [APS Initial Brief, page 6, lines 4-7] However, now that PWCC and PWEC apprehend
24 difficulty in arranging for permanent financing of these generation assets, they look to APS and its
25 creditworthiness to ‘bail’ them out, although there is no evidence in the record that PWCC ever
26 intended to share the benefits of its reduced interim financing costs with APS or its ratepayers.”
27 (Sempra/SWPG/Bowie Reply Br. at 3-4)

28 Sempra/SWPG/Bowie also notes the “failure of APS (and its unregulated parent and

1 generation affiliate) to avail itself of the Commission's invitation in Decision No. 65154 to file an
2 application seeking approval to acquire PWEC's generation assets. Such an application was to be
3 filed on or before September 15, 2002, if APS decided to pursue that course of action. Had it elected
4 to do so, that matter might have been resolved by now; and, perhaps an entirely different scenario
5 might have unfolded without a purported 'liquidity crisis' It is very clear from the record in this
6 proceeding that APS has the financial capacity to issue additional bonds and thus raise funds by
7 which it could have acquired PWEC's generation assets, without the necessity of an accompanying
8 rate increase." (Reply Br. at 4-5)

9 Sempra/SWPG/Bowie is also concerned by APS' acceptance of Staff's recommended
10 condition that the term of the loan not exceed four years, because a four-year loan will not solve
11 PWCC's purported need to arrange permanent financing for PWEC's generation assets, and APS'
12 and PWCC's plan have no "exit strategy" if the Commission grants the financing but denies an APS
13 application to rate base the generation assets. Sempra/SWPG/Bowie believes that APS and PWCC
14 are actually seeking to put the Commission in a position of having no alternative but to approve an
15 APS request for rate base treatment of PWEC assets.

16 **AECC**

17 AECC takes no position on approval of the financing application, but it is concerned about the
18 effect approval will have, *vis a vis* a December 13, 2002 Memorandum from the Director of the
19 Utilities Division to the Commissioners, with an attached document titled "Track 'A' Appeals Issues
20 Principles For Resolution." ("Principles of Resolution") AECC argues that a Commission decision
21 granting the financing without specifically rejecting certain provisions of the Principles of Resolution
22 "will have the effect of: 1) breaking the Commission's reassurance in Decision No. 65154 not to
23 undermine the benefits that the parties have bargained for under the APS Settlement Agreement; 2)
24 amending Decision No. 61973 without complying with the provisions of A.R.S. § 40-252; and 3)
25 may constitute "legal action" by settling litigation currently before the courts without proper notice
26 under Arizona's open meeting law." (AECC Opening Br. at 2-3)

27 **Reliant**

28 In its Opening Post-Hearing Brief, Reliant states that it intervened in this financing docket to

1 “guard against the possibility that the financing application might subvert the efforts of the
2 Commission and numerous parties to develop a fair and open competitive wholesale generation
3 market.” (Reliant Br. at 3) Reliant requests that this Decision expressly find that neither the
4 implementation of the Track B competitive solicitation process nor the Commission’s consideration
5 of whether to authorize APS to acquire PWEC generation assets or their rate base treatment will be
6 prejudiced or adversely affected by this Decision.

7 APS indicates that granting this application will not give PWEC any advantage in meeting the
8 credit requirements in the Track B process, because PWEC will remain without an investment grade
9 rating.

10 ANALYSIS

11 The Company is requesting approval of either an inter-company loan, a guarantee, or a
12 combination of both. The proceeds of the long-term debt incurred by APS would then be loaned to
13 either PWEC or PWCC. The funds would be used to pay off an equivalent amount of PWCC debt
14 previously incurred to finance construction of West Phoenix combined cycle generating units 4 & 5,
15 Saguaro combustion turbine Unit No. 3 and Redhawk Units 1 & 2. As a supplement to a loan, or as
16 an alternative, APS seeks authority to guarantee debt issued by PWEC or PWCC.

17 Applicable Statutes/Regulations

18 Pursuant to Arizona Revised Statutes § 40-285(A), “[a] public service corporation shall not
19 sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its
20 railroad, line, plant, or system necessary or useful in the performance of its duties to the public . . .
21 without first having secured from the commission an order authorizing it to do so.”

22 A.R.S. § 40-301(C) sets forth the minimum requirements that the Commission must find to
23 authorize APS’ issuance of additional debt.

24 **A.R.S. § 40-301**

25 A. The power of public service corporations to issue stocks and stock certificates,
26 bonds, notes and other evidences of indebtedness, and to create liens on their
27 property located within this state is a special privilege, the right of supervision,
28 restriction and control of which is vested in the state, and such power shall be
exercised as provided by law and under rules, regulations and orders of the
commission.

1 B. A public service corporation may issue stocks and stock certificates, bonds, notes
2 and other evidences of indebtedness payable at periods of more than twelve months
after the date thereof, only when authorized by an order of the commission.

3 C. The commission shall not make any order or supplemental order granting any
4 application as provided by this article unless it finds that such issue is for lawful
5 purposes which are within the corporate powers of the applicant, are compatible with
the public interest, with sound financial practices, and with the proper performance
by the applicant of service as a public service corporation and will not impair its
ability to perform that service.

6 Pursuant to A.R.S. § 40-302, the Commission may grant or refuse to grant
7 permission and may attach whatever conditions it deems reasonable and appropriate.
8

9 **A.R.S. § 40-302**

10 A. Before a public service corporation issues stocks and stock certificates, bonds,
11 notes and other evidences of indebtedness, it shall first secure from the commission
12 an order authorizing such issue and stating the amount thereof, the purposes to which
13 the issue or proceeds thereof are to be applied, and that, in the opinion of the
commission, the issue is reasonably necessary or appropriate for the purposes
specified in the order, pursuant to § 40-301, and that, except as otherwise permitted
in the order, such purposes are not wholly or in part, reasonably chargeable to
operative expenses or to income

14 B. The commission may grant or refuse permission for the issue of evidences of
15 indebtedness or grant the permission to issue them in a lesser amount, and may
16 attach to its permission conditions it deems reasonable and necessary. The
17 commission may authorize less than, equivalent to or greater than the authorized or
subscribed capital stock of the corporation, and the provisions of the general laws of
the state with reference thereto have no applications to public service corporations.

18 Pursuant to A.A.C. R14-2-804(B), APS cannot lend to any affiliate not regulated by the
19 Commission or obtain a financial interest in any affiliate not regulated by the Commission, or
20 guarantee, or assume the liabilities of the affiliate, without approval of the Commission. Pursuant to
21 A.A.C. R14-2-804(B), the Commission will review the transactions "to determine if the transactions
22 would impair the financial status of the public utility, otherwise prevent it from attracting capital at
23 fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and
24 adequate service."

25 Obligations of certificated public service corporations

26 As a certificated public service corporation in Arizona, APS has a duty to provide reliable
27 electric service to its customers at reasonable rates. In furtherance of that duty, APS should manage
28 its business and operations to insure that it is financially capable of providing such service. It is in

1 the public interest that APS maintain healthy credit ratings so that APS has access to the capital
2 markets at reasonable terms and rates, as those costs are reflected in rates paid by APS customers.
3 Further, APS has a duty to comply with applicable statutes, regulations, and Commission decisions.

4 Need for APS Credit Support

5 Much of the testimony focused upon who may be downgraded if the financing application is
6 approved or denied. APS argued that neither PWCC nor PWEC can refinance the existing PWCC
7 debt at reasonable terms without support from APS. APS further argues that PWCC will be
8 downgraded if the application is denied and APS will be downgraded if PWCC is downgraded. APS
9 argues that a downgrade would impair its ability to obtain credit to support its utility operations and
10 possibly interfere with its ability to provide electric service. Staff and RUCO agreed with APS'
11 conclusions. Panda argued that PWCC could refinance the debt and that if APS issues debt to loan to
12 PWEC, it is likely to be downgraded, and at the very least, its credit quality will suffer.

13 Staff believes that a rating downgrade at APS could interfere with APS' ability to provide
14 electric service to the public – it could result in increases in cost of capital, potential lack of access to
15 the capital markets, potential increases in collateral requirements, and an inability to do business with
16 vendors. Staff concluded that “there is some risk of ratings downgrade to PWCC, and as a
17 consequence, to APS.” (Staff Initial Br. at 3-4) Although Staff believes that “the evidence on this
18 issue is clothed in conjecture and speculation, significant evidence nonetheless supports the
19 conclusion that PWCC is at risk for credit downgrades. As a consequence, APS faces a similar risk.”
20 (Ibid at 4).

21 Rating agency reports indicating a potential for a PWCC downgrade include a December
22 2002 Fitch report stating “[f]ailure to obtain the inter-company loan or access alternate sources of
23 funding would result in a downgrade of PNW” (APS-2, Ex. BMG-2R); Standard and Poor's
24 November 4, 2002 report stating “[t]he stable outlook reflects the assumption that the ACC will
25 approve the application by PWCC to issue up to \$500 million at APS to repay a portion of the \$750
26 million bridge financing at PWCC” (Staff Ex.4); and a December 30, 2002 Moody's report stating
27 “PWCC's rating outlook is stable and incorporates the view that the ACC will adopt the staff
28 recommendation concerning the APS financing application, which should allow for a successful

1 refinancing of PWCC debt.” (APS Ex. 5).

2 The likelihood of an APS downgrade in the event of a PWCC downgrade is more speculative.
3 Staff’s witness testified that he could not state for a fact that APS would be downgraded, but cited the
4 December 30, 2002 Moody’s Opinion update (APS Exh. 5) which states: “APS’ rating outlook is
5 stable and incorporates the view that the ACC will adopt the staff recommendation concerning the
6 APS financing application and other Track A issues. Moody’s notes that while APS’ coverages may
7 decline if the financing application is approved, the resulting credit metrics should remain consistent
8 with the current rating, particularly when one considers the benefits to bondholders of having APS
9 remain vertically integrated.” Staff acknowledges that the report is subject to interpretation, but
10 believes that it implies that APS’ ratings outlook is stable as long as the financing application is
11 approved.

12 Panda’s witness testified that APS acquiring additional debt to loan to PWEC should result in
13 a downgrade of APS, whereas, PWCC refinancing its existing bridge debt should not result in a
14 downgrade of PWCC or APS. Logically, this analysis makes sense. However, we do not know what
15 APS told the rating agencies – since Ms. Gomez sent them her testimony that indicates that APS
16 seeks to rate base these assets, we do not know whether or how this information was factored into the
17 agency opinions. Therefore, it is possible that APS may be downgraded if APS led the rating
18 agencies to believe that the assets are going to be rate based, and that the assets had an assured cash
19 flow.

20 This testimony and evidence on the need for APS credit support consists of speculation on
21 actions that third parties may take as a result of our decision. Our foremost concern and guiding
22 principle is what is in the best interest of the ratepayers of APS. Although it is not clear to us that
23 APS would be downgraded if this financing application is denied, we are not willing to risk that since
24 we believe that with appropriate conditions, we can minimize the effects of the financing on the
25 ratepayers. Accordingly, APS should be authorized to provide credit support.

26 Form of APS Credit Support – Loan and/or Guarantee

27 APS seeks either a loan and/or a guarantee. Staff supports only a loan, and Panda supports
28 only a guarantee.

1 Loan

2 Panda and other intervenors urge the Commission not to approve a loan because it does not
3 maintain separation between APS and its affiliate; it would undermine wholesale competition; and
4 because APS' credit quality would not suffer as much as with a guarantee.

5 We stated in Decision No. 65434 (December 3, 2002), that we would examine ways to
6 improve the regulatory insulation between APS and its affiliates in this docket. We are also concerned
7 about regulatory insulation, but find that Panda's concerns about a loan can be addressed in the
8 conditions we place upon a loan, by monitoring subsequent events including the Track B solicitation,
9 and through our Affiliated Interest Rules.¹⁰ Further, we are not adopting RUCO's recommended
10 requirement that APS file an application to acquire or rate base the PWEC assets, and none of the
11 proceeds will be used for or to support PWEC's non-Arizona generation assets.

12 Although APS' witness Tildesley testified that for purposes of determining the impact on
13 APS, he assumed no repayment capacity at PWEC, we are approving this financing based upon the
14 testimony of President and Chief Executive Officer for APS and the President of PWCC, Jack Davis,
15 that if PWEC did not win any bids in the Track B competitive procurement, that PWEC would sell its
16 power out into the wholesale market, and that that would generate sufficient funds to pay the loan to
17 APS. (Davis Tr. p. 641). Additionally, APS will soon be filing a rate case and we can take further
18 action to protect ratepayers at that time, if necessary. Therefore, if there are any negative effects of
19 the financing (in addition to Staff's identified capital cost concerns), we will insure that APS'
20 ratepayers are held harmless. Further, we will require that APS notify the Commission in the event
21 of a default on the loan, so that the Commission can take appropriate action.

22 APS generally agreed with Staff's conditions for a loan approval, but requested modification
23 of Condition 3 to reduce the point spread from 264 to 150. APS believes that Staff's premium is
24 excessive and "substantially overstates the risk undertaken by APS". APS' point spread corresponds
25 to the difference between APS' credit rating and the rating APS believes PWEC would have obtained
26 absent Decision No. 65154. Staff believes that the loan should be priced at an appropriate market rate

27

28 ¹⁰ See discussion and conditions hereinafter in the Affiliated Interest Rules section.

1 PWEC's current status reflects a BB minus rating which is not investment grade. Staff's basis point
2 risk premium is designed to insure that APS will be compensated for the actual risk associated with
3 lending money to PWEC. We agree with Staff that APS should be compensated for the actual risk
4 and given PWEC's acknowledgement that it could not obtain project financing even prior to Decision
5 No. 65154,¹¹ believe that Staff's premium is appropriate.

6 APS proposes that the Commission adopt its clarification to Condition 7, by defining the
7 calculation of the amount of common equity to mean calculated on a quarterly basis, using APS' 10-
8 Q or 10-K filings with the Securities and Exchange Commission. Using the reported APS balance
9 sheet accounts, APS' common equity would be divided by the sum of such common equity and APS
10 long-term debt (including current maturities of such debt). Staff did not disagree with this method.
11 However, it is not clear from APS' clarification if this new debt is to be included in the calculation,¹²
12 so we will approve APS' clarification with the condition that the debt financing approved herein will
13 be included in the calculation.

14 Accordingly, we will adopt Staff's recommended conditions to APS' financing, with the
15 clarifications above.

16 Guarantee

17 In its Initial Brief, APS indicates that although it initially requested either a loan or a
18 guarantee, if forced to choose between the two, it prefers the loan option, primarily because of timing
19 – it believes that the financial markets are more familiar with APS debt so an APS loan would be
20 easier and quicker than if potential lenders must do “market discovery” on PWEC. This is especially
21 so if “it is determined that PWEC should register its debt with the SEC as an initial public offering
22 rather than place debt privately.” APS also believes that Staff's conditions would be difficult to
23 implement with a guarantee. Further, APS believes that an APS loan would “reduce future issues
24 involved in the determination by the Commission of the ultimate ratemaking treatment” of the PWEC
25 assets because “it minimizes any subsequent costs of assuming or refunding the PWEC debt being
26 guaranteed by APS.” (APS Initial Br. at 25) Further, a guarantee would be more costly to PWEC.

27 _____

28 ¹¹ Tr. At 211

¹² Staff recommends a maximum term of four years, which would likely not be included in long-term debt.

1 APS believes that Panda's three critical conditions on a guarantee should be rejected as
2 impractical, unnecessary, and contrary to APS' customers' best interests. APS criticizes Panda's
3 requirement that PWEC assets should be pledged to a third-party lender as directly conflicting with
4 Staff's Condition No. 2; that a requirement that a third-party lender execute on PWEC assets before
5 seeking payment from APS would make the financing unmarketable; and that precluding APS from
6 bidding on PWEC assets in an auction would violate a fundamental principle in commercial secured
7 transactions that "a creditor is entitled to protect its own equity in an investment by bidding at least
8 its secured amount into any auction" (APS Closing Br. at 15); and would prevent the Commission
9 from ever considering the used and usefulness of the plants.

10 Staff opposed APS' request to guarantee the debt issued by PWCC or PWEC because Staff
11 believes that it is "undefined, impractical, ill suited by the circumstances of the case, and unsupported
12 by the record." (Staff Initial Br. at 6) Even if a guarantee were well defined, Staff believes that a loan
13 would better protect ratepayers because an explicit loan with a stated interest rate would set forth the
14 APS risk exposure. Further, Staff is concerned with the timing and complexity of a guarantee and
15 believes that a guarantee would interfere with Staff's condition that APS hold a security interest in
16 the PWEC assets. In response to Panda's argument that a guarantee would maintain separation
17 between APS and its affiliates, Staff states that although regulatory insulation is important, it would
18 be unreasonable to structure this transaction around that single goal.

19 We believe that APS should have the flexibility to use the guarantee option if it would be in
20 the best interests of ratepayers. Although none of the parties are as familiar with such a guarantee,
21 we believe that it is possible to structure such a guarantee to address the concerns raised by Staff in
22 its proposed conditions to the loan approval. Not all of the debt to be refinanced is due this summer,
23 and it may be possible to use a combination of debt now and guarantee later. If APS chooses to use
24 the guarantee option, it shall consult with Staff to make sure that the transaction's structure meets
25 Staff's concerns. We find that Panda's proposed restriction limiting APS' ability to bid at auction to
26 preserve its equity is not in the public interest.

27 Compliance with A.R.S. § 40-301

28 In response to Sempra/SWPG/Bowie argument that the financing is not within its corporate

1 powers, APS argues that its current Articles of Incorporation were adopted in 1988 under Title 10 of
2 the Arizona Revised Statutes. A.R.S. § 10-054(A)(4) required all corporations to include in their
3 articles of incorporation a brief statement of character of business the corporation intends to actually
4 conduct, but the statement did not limit the character of business that the corporation ultimately
5 conducted. Further, pursuant to A.R.S. § § 10-301 & 302, corporations have the power to pledge
6 property, borrow and lend monies, and engage in any lawful activity.” APS argues that the language
7 included in its Articles of Incorporation to comply with the then-applicable 1976 Arizona Business
8 Corporation Act did not act as an implied limitation to the broad “purposes” paragraph of the
9 Articles. We agree and find that the financing is for lawful purposes within APS’ corporate powers.

10 Generally, a public service corporation borrowing funds to lend to an affiliate to refinance
11 assets would not be considered to be in the public interest, to be consistent with sound financial
12 practices, nor to be within the proper performance of its duties as a public service corporation. In
13 fact, we adopted Affiliated Interest Rules in order to ensure that utility ratepayers are insulated from
14 the dangers inherent in holding company structures and diversification. Their purpose is to make
15 sure that ratepayers do not pay rates for utility service that include costs associated with the holding
16 company structure, including financially beleaguered affiliates and “sweetheart deals with affiliates
17 intended to extract capital from the utility to subsidize non-utility operations.” However, we believe
18 that with the conditions imposed in this decision, those goals can be met. Taking into account the
19 events that have happened in the move to deregulate the electric industry, on both a national and local
20 basis, including the current state of the financial markets, the public interest may require approval of
21 some unusual requests that seemingly are not related to a utility’s proper performance of its duties as
22 a public service corporation. It is under this unique backdrop that we must analyze whether we can
23 make the findings required by statute to approve this financing.

24 Approval of the financing will allow APS to use the borrowed funds to protect its own credit
25 rating, and in that context, the financing is within the proper performance of its duties as a public
26 service corporation. According to the rating agencies, APS’ health will remain stable, even with the
27 additional debt. Although Staff found that APS has significant needs for capital for the regulated
28 utility operations over the coming years and issuing debt to loan to PWEC would diminish APS’

1 ability to obtain its own debt capital, the condition that the loan not exceed four years and APS'
2 ability to fund capital expenditures from internally-generated funds together with the restriction on
3 payment of dividends, will prevent the financing from impairing APS' ability to perform its service
4 as a public service corporation. Generally, a utility issuing debt to finance assets owned by an
5 affiliate is not consistent with sound financial practices, but with conditions of Staff, including the
6 security interest in the PWEC assets and the interest premium paid by PWEC, there will be no
7 "sweetheart deal" extracting capital from APS. Staff's witness testified that the financing is not
8 obviously compatible with the public interest, but with conditions, it will protect APS' credit rating
9 which will insure that APS can continue to provide electric service to its customers at a reasonable
10 cost. We conclude that APS' financing with the conditions adopted herein, will be compatible with
11 the public interest if, by preventing a downgrade in APS' credit rating, it prevents a substantial
12 disintegration in APS' ability to provide service.

13 In December 2002, PWCC raised approximately \$200 million in net proceeds from the sale of
14 common stock and the proceeds were used for debt reduction at PWCC. We believe that it is
15 appropriate for PWCC to improve its overall financial health, but not at the expense of APS
16 ratepayers. Accordingly, consistent with APS' argument that a downgrade to PWCC would result in
17 a downgrade of APS, and in recognition of our approval of the financing, we expect that PWCC not
18 take any actions (including issuing debt or equity) that would result in a downgrade to itself or to
19 APS.

20 Through this financing application, PWCC is attempting to share the financial risks associated
21 with the PWEC assets with APS. There is no evidence that APS analyzed the developing wholesale
22 market and requested PWCC to build such assets¹³, and in fact, APS was obligated to purchase its
23 power for Standard Offer customers from the competitive market, not through a PPA with its
24 affiliate. PWCC's supposed claim "damages as a result of Decision No. 65154" rings hollow when
25 one looks at the circumstances under which PWEC obtained its investment grade credit, especially
26 against the background of our admonitions contained in Decision No. 61973,¹⁴ and given APS'

27 ¹³ Tr. p 281

28 ¹⁴ See Tr. p 275; pp 649-50

witness' testimony that by the time she started talking to bankers about refinancing options in the fall/winter of 2001¹⁵; the options were basically the same as today. Nevertheless, we find ourselves in the situation where it appears that some action must be taken to prevent APS ratepayers from potential harm resulting from APS' parent's decision to build generation and to finance that generation with "bridge debt", in combination with the circumstances that currently exist in the financial markets. We believe that with the conditions contained herein, approval of the application is in the public interest.

Continuing Long-Term Indebtedness

As of June 30, 2002, APS had total outstanding long-term indebtedness in an aggregate principal amount of approximately \$2,206,780,000. Decision No. 55017 (May 6, 1987)¹⁶ allows APS to have outstanding up to an aggregate principal amount of long-term indebtedness of \$2,698,917,000. Accordingly, APS has approximately \$492,137,000 in additional long-term debt authorization outstanding. APS views having such a debt margin as a "critical component of the financing flexibility afforded by the 1986 Order." (Application p. 10) APS requests that the Commission maintain the current margin under the Continuing Debt limit by not treating the new debt as Continuing Debt under the 1986 and 1984 Orders. Staff did not object to such treatment. Although we are not counting the new debt as continuing debt, we are including the \$500,000,000 in APS' capital structure for purposes of calculating the minimum 40 percent common equity ratio requirement for APS to issue dividends. Staff testified that "APS has significant needs for capital for regulated utility operations over the coming years" (Exhibit S-1, Thornton p. 1). APS' needs for capital for its regulated public utility service take precedence over PWCC's desire for dividends from APS. Accordingly, in the proper performance of its duties as a public service corporation, APS' financial decisions shall be governed by those duties, and not by the needs of its parent or affiliates. APS shall not forgo funding for needed utility operations so that it can pay dividends to its parent.

ASP Debt – Secured or Unsecured

On February 20, 2003, the Federal Energy Regulatory Commission ("FERC") issued a news

¹⁵ Well before Decision No. 65154, issued in September 2002.

¹⁶ The 1986 Order superseded the long-term indebtedness limitation granted APS in Decision No. 54230 (November 8, 1984) (1984 Order).

1 release "Commission Sets New Conditions For Utility Debt Acquisition" and on February 21, 2003,
2 issued its "Order Conditionally Granting Authorization to Issue Long-Term Unsecured Debt and
3 Announcing New Policy on Conditioning Securities Authorizations" in Docket No. ES02-52-000,
4 concerning Westar Energy, Inc.

5 Section 204 of the Federal Power Act ("FPA") provides that requests for authority to issue
6 securities or assume liabilities shall be granted if FERC finds that the issuance:

- 7
- 8 (a) is for some lawful object, within the corporate purposes of the applicant, and
9 compatible with the public interest, which is necessary or appropriate for or
10 consistent with the proper performance by the applicant of service as a public
11 utility and which will not impair its ability to perform that service, and (b) is
12 reasonably necessary or appropriate for such purposes.

13 Section 204 of the FPA does not apply to a public utility organized and operating in a state
14 where its securities issuances are regulated by a state commission. Accordingly, jurisdiction over
15 APS' financing application is with this Commission. We note the similarities of Arizona's financing
16 statutes with Section 204 of the FPA and therefore, in addition to our consideration of state law, will
17 consider and evaluate APS' application in light of FERC's newly announced conditions. Those
18 conditions are:

- 19 · public utilities seeking authorization to issue debt backed by a utility asset must
20 use the proceeds of the debt for utility purposes only;
21 · if any utility assets that secure debt issuances are 'spun off,' the debt must follow
22 the asset and also be 'spun off';
23 · if any of the proceeds from unsecured debt are used for non-utility purposes, the
24 debt must follow the non-utility assets. If the non-utility assets are 'spun off,' then
25 proportionate share of the debt must follow the 'spun off' non-utility asset; and
26 · if utility assets financed by unsecured debt are 'spun off' to another entity, then a
27 proportionate share of the debt must also be 'spun off'.

28 The stated purpose of the conditions is "to prevent public utilities from borrowing substantial
amounts of money and diverting the proceeds to finance non-utility businesses."

Under these FERC conditions, APS could not issue debt secured by its assets because the
proceeds of the debt are not being used for a utility purpose, but are being used to lend funds to an
affiliate to refinance affiliate debt. Further, if the funded non-utility assets are 'spun off', then the debt

1 must follow the assets. Under this analysis, the non-utility assets are already divested or 'spun off'
2 since they are owned by PWEC, and APS would essentially be acting as a secured lender. We believe
3 that our condition to require APS to obtain a security interest in the PWEC assets assures that the debt
4 follows the assets, and the interest premium paid by PWEC will compensate APS for its risk. We
5 agree that it is not in the public interest for APS to use its assets to secure its debt and will limit the
6 debt APS issues to unsecured debt only. As indicated hereinafter, we will further condition approval
7 on APS and its affiliate's agreement to be bound by all the Affiliated Interest Rules, including those
8 that APS obtained a waiver from in Decision No. 61973, during the terms of the loan and/or guarantee.

9 Principles of Resolution

10 AECC believes that the Commission should reject certain provisions of the Principles of
11 Resolution. Notwithstanding Staff and APS' agreement, any party may object to the inclusion of
12 those issues in the rate case, and the presiding officer can determine the appropriate scope of the
13 proceeding.¹⁷ However, as we said in Decision No. 65154, "[a]ccordingly, we will direct Staff to
14 open a rulemaking docket to address any required changes to rules, and will keep this docket open for
15 parties to file comments upon what other decisions/issues may need to be revisited." (p. 27) APS'
16 ability to raise these issues may be limited by the Settlement Agreement, but until such time as that
17 issue is before us, APS should comply with the terms of the Settlement Agreement if it seeks to
18 modify issues resolved therein. Our approval of this financing application with the knowledge that
19 Staff has filed its Principles of Resolution does not mean that we consider the Commission a party to
20 the 1999 Settlement Agreement and have agreed to reopen the 1999 Settlement Agreement, nor is it
21 intended to indicate our agreement that the issues set forth in the Principles of Resolution will be
22 decided by us in the rate case. The Staff's Principles of Resolution is essentially an agreement by
23 Staff not to object to APS' inclusion of these issues in the rate case, and does not eliminate APS'
24 obligations to parties under the Settlement Agreement, or under A.R.S. § 40-252. As is clear in our
25 discussion herein, our decision to approve the financing application with the conditions contained
26 herein is not based upon APS' assertion that Decision No. 65154 "caused damages to APS" and is

27 _____
28 ¹⁷ It is possible that other parties may propose to address additional issues as well, such as APS' recovery of stranded costs from its ratepayers.

1 not related to scolding the appeal filed by APS.

2 APS notes that it can withdraw portions of its Track A appeal on its own, with or without
3 Commission action.

4 Track B – Competitive Procurement

5 As stated in the Company's application, "APS also wishes to make it clear that this
6 Application does not affect nor is it intended to affect the Commission's consideration of, or the
7 Company's position on, any of the 'Track B' issues identified in Commission Docket No. E-00000A-
8 02-0051. This too was an express part of the Commission's order in Decision No. 65154 (*Id.* at
9 pp.33-34, Tenth Ordering Paragraph.)" (Application p. 4) APS indicates that granting this
10 application will not give PWEC any advantage in meeting the credit requirements in the Track B
11 process, because PWEC will remain without an investment grade rating.

12 Accordingly, the public interest requires that any improvement in PWEC's credit worthiness
13 as a result of approval of this financing not be considered or used in the evaluation of bids/offers
14 during APS' competitive procurement. This will help neutralize possible "preference to an affiliate"
15 incentives that may be created by approval of this financing. Further, we believe that we have
16 structured the Track B proceeding to prevent favoritism..

17 Reliant requests that this Decision expressly find that neither the implementation of Track B
18 competitive solicitation process nor the Commission's consideration of whether to authorize APS to
19 acquire PWEC generation assets or the rate base treatment will be prejudiced or adversely affected by
20 this Decision.

21 Affiliated Interests Rules

22 Pursuant to Decision No. 61973 (October 6, 1999), APS was granted various waivers of the
23 Commission's Public Utility Holding Companies and Affiliated Interests rules. Specifically, APS
24 was granted waivers of:

- 25 • "R14-2-801(5) and R14-2-803, such that the term 'reorganization' does not include,
26 and no Commission approval is required for, corporate restructuring that does not
27 directly involve the utility distribution company ('UCD') in the holding company. For
28 example, the holding company may reorganize, form, buy or sell non-UDC affiliates,
acquire or divest interests in non-UDC affiliates, etc., without Commission approval";
- R14-2-805(A) "shall apply only to the UDC."

- R14-2-805(A)(2)
- R14-2-805(A)(6)
- R14-2-805(A)(9), (10), and (11).

R14-2-805(A) provides:

On or before April 15th of each calendar year, all public utilities meeting the requirements of R14-2-802 and public utility holding companies will provide the Commission with a description of diversification plans for the current calendar year that have been approved by the Boards of Directors. As part of these filings, each public utility meeting the requirements of R14-2-802 will provide the Commission the following information:

1. The name, home office location and description of the public utility's affiliates with whom transactions occur, their relationship to each other and the public utility, and the general nature of their business;
2. *A brief description of the business activities conducted by the utility's affiliates with whom transactions occurred during the prior year, including any new activities not previously reported;*
3. A description of plans for the utility's subsidiaries to modify or change business activities, enter into new business ventures or to acquire, merge or otherwise establish a new business entity;
4. Copies of the most recent financial statements for each of the utility's subsidiaries;
5. An assessment of the effect of current and planned affiliated activities on the public utility's capital structure and the public utility's ability to attract capital at fair and reasonable rates;
6. *The bases upon which the public utility holding company allocates plant, revenue and expenses to affiliates and the amounts involved; an explanation of the derivation of the factors; the reasons supporting that methodology and the reasons supporting the allocation;*
7. An explanation of the manner in which the utility's capital structure, cost of capital and ability to raise capital at reasonable rates have been affected by the organization or reorganization of the public utility holding company;
8. The dollar amount transferred between the utility and each affiliate during the annual period, and the purpose of each transfer;
9. *Contracts or agreements to receive, or provide management, engineering, accounting, legal, financial or other similar services between a public utility and an affiliate;*
10. *Contracts or agreements to purchase or sell goods or real property between a public utility and an affiliate; and*
11. *Contracts or agreement to lease goods or real property between a public utility and an affiliate.*

We believe that as a condition to our approval of the financing herein, and in order to protect APS' security interests in PWEC's generation assets and to promote the public interest, neither PWCC nor PWEC shall reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval. Further, we believe that the public interest

1 requires that during the term of the loan or guarantee, APS and its affiliates must comply with all the
2 Affiliated Interest Rules. Accordingly, we will make this a condition to our approval of this
3 financing application.

4 Further, we believe that a preliminary investigation into APS, PWCC, and PWEC's actions
5 related to the transition to electric competition, particularly compliance with our electric competition
6 rules and with Decision No. 61973 and APS' activities with its affiliates should be undertaken by
7 Staff. Of concern to us is testimony and evidence elicited during this hearing of the PWCC
8 enterprise's possible use of APS (both its generation assets and captive ratepayers) to gain advantage
9 in the developing competitive environment. One example is how APS' Treasurer described the way
10 that PWEC was able to obtain an investment grade rating¹⁸; another is APS' application for an air
11 quality permit on behalf of PWEC. Although some may argue that our granting approval of the
12 financing request is another example, we have carefully tried to neutralize any competitive advantage
13 that may accrue to PWEC as a result of our approval. Nothing in this Decision condones actions
14 taken by APS, PWEC, or PWCC, it is merely an attempt to prevent harm to APS ratepayers.
15 Additionally, we are not intending our approval to constitute state action for the purposes of antitrust
16 laws.

17 When asked whether Decision No. 61973 was presented as part of the presentation to the
18 rating agencies, APS' Treasurer responded that: "[w]ell, we would have modeled what the Order
19 required in our presentation, yes." (Gomez, Tr. p. 275) When asked whether she was familiar with
20 the following quote from Decision No. 61973 at p. 10 which states: "[w]e share the concerns that the
21

22 ¹⁸ Information provided to the rating agencies by PWCC et al. By the Spring of 2001, PWEC obtained a contingent
23 investment grade rating. (See Tr. At 281-282) Testimony and evidence indicate that PWEC made presentations to rating
24 agencies indicating that PWEC was under contract to sell its output to APS under a four year purchase power agreement.
25 (See Panda Exh. 4, 5, Gomez Tr. At 150, 276) In September, 2002, APS asked the credit rating agencies to withdraw
26 PWEC's credit rating. APS would have been required to begin purchasing 100% of its standard offer power from the
27 competitive market by January 1, 2001, if it had not obtained a 2 year waiver in its Settlement Agreement. During that 2
28 year period, APS' parent formed competitive affiliates, including PWEC, and PWCC/PWEC built 4 new generating units
and obtained a contingent investment grade rating for PWEC. If the Commission had not stayed divestiture of its assets,
on January 1, 2003, APS would have been acquiring 100% of its standard offer power from the competitive market, with
no ability to change its rates until at least July, 2004. APS' position in this application that these assets were "dedicated"
to APS customers shows possible intended noncompliance with the Commission's electric competition rules and/or
possible anti-competitive activity.

1 noncompetitive portion of APS not subsidize the spun-off competitive assets through an unfair
2 financial arrangement”, APS Treasurer Gomez stated that she was not familiar with that sentence.
3 (Gomez, Tr. p. 275). Ms. Gomez testifies that there was no contract, but was a modeling assumption.
4 She further testified that the investment grade rating was not based upon just the unification of assets,
5 but it is also based upon the cash flow from those assets. (Gomez, Tr. pp. 277-278; 281-282) During
6 cross-examination of Jack Davis, he testified about documents prepared by PWEC for a Rating
7 Agency Presentation in February 2001.¹⁹ Mr. Davis testified that the document discussed a “PPA
8 between Pinnacle West Power Marketing & Trading, and Pinnacle West Energy” and also a PPA
9 between APS and it “goes on to represent how Pinnacle West Marketing & Trading will make those
10 deliveries to Arizona Public Service.” Mr. Davis testified that a page entitled “PWEC Credit
11 Strengths” shows the first arrow indicates “Four year fixed price contract” and “The majority of
12 generation is dedicated to APS load through 2004”. (Tr. pp. 729-730)

13 The date of 2004 is significant, because the APS rates set in Decision No. 61973 were to
14 remain in effect until at least June 30, 2004. However, from January 1, 2003 until June 30, 2004,
15 APS was to be purchasing power from the competitive market (without an adjustor in place) and
16 would have been exposed to the price difference between the “market price” and the APS Standard
17 Offer rates.

18 Decision No. 61973 provided that: “Such Code of Conduct should also include provisions to
19 govern the supply of generation during the two-year period of delay for the transfer of generation
20 assets so that APS doesn’t give itself an undue advantage over the ESPs”. (p. 12)

21 “Some parties were concerned that Sections 4.1 and 4.2 provide in effect that the Commission
22 will have approved in advance any proposed financing arrangements associated with future transfers
23 of ‘competitive services’ assets to an affiliate. As a result, there was a recommendation that the
24 Commission retain the right to review and approve or reject any proposed financing arrangements. In
25 addition, some parties expressed concern that APS has not definitively described the assets it will
26 retain and which it will transfer to an affiliate. We share the concerns that the non-competitive

27
28 ¹⁹ Panda Exhibit 22 was admitted under seal, but the cross examination of Mr. Davis was not confidential. This discussion will refer only to the non-confidential testimony on that document.

1 portion of APS not subsidize the spun-off competitive assets through an unfair financial arrangement.
 2 We want to make it clear that the Commission will closely scrutinize the capital structure of APS at
 3 its 2004 rate case and make any necessary adjustments.” (Decision No. 61973 at p. 10)

4 We want to make clear that the Commission did not require APS or PWCC to form an
 5 affiliate to acquire APS generation assets; the Commission did not require APS to purchase power
 6 from an affiliate²⁰; the Commission has never reviewed the prudence of the decision to construct the
 7 PWEC generation assets; the Commission has never reviewed the prudence of the costs to construct
 8 the PWEC generation assets; the Commission did not approve PWCC’s decision to finance the
 9 PWEC assets at the holding company level (or even know of such financing) or the maturities of the
 10 debt; nor has the Commission denied APS the ability to construct needed generation assets.
 11 Although APS asserts that under its Code of Conduct, the Electric Competition Rules, and Decision
 12 No. 61973, it could not construct generation, Staff, in its Responsive Brief, states that “APS will
 13 argue that its code of conduct prevented it from building the assets at APS, (Tr. at 520); nonetheless,
 14 an examination of that document does not clearly support that conclusion.” (Staff Responsive Br. at
 15 5). We agree.

16 Miscellaneous

17 The issue transferring PWEC assets to APS is not before us in this application. RUCO
 18 recommended that we approve this financing and order APS to file an application to transfer the
 19 assets. APS indicated it would not be appropriate for the Commission to require a proceeding
 20 seeking transfer of the PWEC assets to APS at this time, and believes that Staff’s Condition No. 2
 21 provides essentially the same protection. We will not adopt RUCO’s recommendation.

22 * * * * *

23 Having considered the entire record herein and being fully advised in the premises, the
 24 Commission finds, concludes, and orders that:

25
 26
 27 ²⁰ APS did not demonstrate that the Commission knew or approved that APS would or intended to purchase power from
 28 an affiliate. In fact, APS had requested and obtained a waiver of A.A.C. R14-2-805(A)(10) which meant that APS did not
 have to provide the Commission with contracts or agreements to purchase or sell goods or real property between a public
 utility and an affiliate.

FINDINGS OF FACT

1
2 1. APS is a public service corporation principally engaged in furnishing electricity in the
3 State of Arizona. APS provides either retail or wholesale electric service to substantially all of
4 Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the
5 Phoenix metropolitan area. APS also generates, sells and delivers electricity to wholesale customers
6 in the western United States.

7 2. On September 16, 2002, APS filed an application requesting approval of financing in
8 the form of either an inter-company loan and/or a guarantee of debt to allow PWCC or PWEC to
9 refinance bridge debt incurred by PWCC in the construction of certain PWEC generation assets.

10 3. Notice of the application was provided in accordance with the law.

11 4. Intervention was granted to RUCO, Panda, Reliant, Harquahala, the PPL entities,
12 AUIA, SWPG/Bowie, Sempra, ACPA and TEP.

13 5. The hearing commenced on January 8, 2003 and testimony and evidence was taken
14 over five days of hearing. Initial Briefs were filed on January 27, 2003, and Reply Briefs were filed
15 on February 6, 2003.

16 6. APS' parent, PWCC, has incurred approximately \$1 billion in debt financing the
17 construction of generating units at PWEC, its merchant subsidiary.

18 7. PWCC used debt with short-term maturities because it planned for PWEC to refinance
19 the debt at an investment grade once the APS rate-based generation assets were transferred to PWEC.

20 8. In the spring of 2001, PWCC made presentations to rating agencies on behalf of
21 PWEC and obtained a contingent investment grade rating for PWEC.

22 9. By the fall of 2001, project financing for the PWEC generation assets was no longer
23 available.

24 10. On October 18, 2001, APS filed an application for approval of a Variance/Purchased
25 Power Agreement. The application stated that "adherence to the competitive bidding requirements of
26 the Electric Competition Rules will not produce the intended result of reliable electric service for
27 Standard Offer customers at reasonable rates," requested that the Commission grant a partial variance
28 to R14-2-1606(B) that would otherwise obligate APS to acquire all of its customers' Standard Offer

1 generation requirements from the competitive market, and sought Commission approval of a long-
2 term purchase power agreement with its parent, PWCC.

3 11. By Procedural Order issued May 2, 2002, a generic proceeding was established that
4 set up Track A to resolve issues relating to market power, divestiture, codes of conduct/affiliate
5 transactions and jurisdictional issues, and Track B to address competitive procurement.

6 12. On September 10, 2002, the Commission issued Decision No. 65154 in the Track A
7 proceeding wherein the Commission ordered APS to cancel any plans to divest interests in any
8 generating assets.

9 13. On March __, 2003 the Commission issued Decision No. ____, the Decision in the
10 Track B proceeding.

11 14. Currently, there is turmoil in the financial markets and the wholesale electric market is
12 volatile.

13 15. APS seeks authorization to issue up to \$500 million of debt, and APS would loan the
14 proceeds of that debt to PWCC or PWEC to be used to retire PWCC's existing debt.

15 16. In addition, or in the alternative, APS seeks approval to guarantee debt that may be
16 issued by PWCC or PWEC to retire PWCC's existing debt.

17 17. The total amount of financing authority requested does not exceed \$500 million.

18 18. RUCO recommended approval of the loan with conditions, including that the
19 Commission require APS to file an application to transfer the PWEC assets to APS.

20 19. Panda and various intervenors recommended that the Commission not grant the
21 requested financing, but if some financing is approved, it should be in the form of a guarantee with
22 certain conditions.

23 20. Staff recommended that the Commission authorize APS to borrow \$500 million in
24 order to loan the proceeds to PWEC, with seven conditions.

25 21. As a certificated public service corporation, APS has a duty to provide reliable electric
26 service to its customers at reasonable rates.

27 22. It is in the public interest that APS maintain healthy credit ratings so that it has access
28 to the capital markets at reasonable terms and rates.

23. APS could face a downgrade if PWCC is downgraded, and such a downgrade of APS could interfere with APS' ability to provide electric service to the public at reasonable rates if it resulted in increases in the cost of capital, potential lack of access to the capital markets, potential increases in collateral requirements, and an inability to do business with vendors.

24. APS' requested financing will be compatible with the public interest if, by preventing a downgrade in APS' credit ratings, it prevents a substantial disintegration in APS' ability to provide reliable service at reasonable rates.

25. Because the transaction poses some risks to the Company and to its ratepayers, we will require conditions to approval of the financing, including Staff's seven conditions and conditions that the debt authorized herein will be included in the capital structure calculation to determine whether APS can issue dividends; that any guarantee shall meet the same concerns identified in Staff's seven conditions; APS shall inform the Commission in the event of a loan default so that the Commission can take appropriate action; APS' debt issuance be for unsecured debt only; that neither PWCC nor PWCC shall reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval; and that during the term of the loan or guarantee, APS and its affiliates must comply with all the Affiliated Interest Rules.

26. It is in the public interest to grant authority for both a loan and a guarantee with the conditions attached hereto, so that Arizona Public Service can structure the transaction in a manner that will provide the most protection for its ratepayers.

27. The issue of the purpose for which the PWEC assets were built is not before us in this proceeding, and we are making no determination as to whether or not those assets should be part of APS' rate base.

28. Testimony and evidence presented during the hearing merit a preliminary investigation by Staff into APS' compliance with Decision No. 61973, the Electric Competition Rules, its Code of Conduct, and applicable law.

CONCLUSIONS OF LAW

1. Arizona Public Service Company is a public service corporation within the meaning of

1 Article XV of the Arizona Constitution and A.R.S. §§ 40-285, -301, and 40-302 and A.A.C. R-14-2-
2 804.

3 2. The Commission has jurisdiction over Arizona Public Service Company and the
4 subject matter of the application.

5 3. Notice of the application was provided in accordance with the law.

6 4. APS' application should be approved consistent with the Discussion, Analysis, and
7 Findings of Fact herein.

8 5. The financing with the conditions approved herein is for lawful purposes within
9 Arizona Public Service Company's corporate powers, is compatible with the public interest, with
10 sound financial practices, and with the proper performance by Arizona Public Service Company of
11 service as a public service corporation, and with the conditions approved herein, will not impair
12 Arizona Public Service Company's ability to perform that service.

13 6. The financing with the conditions approved herein is for the purposes stated in the
14 application and is reasonably necessary for those purposes, and such purposes may, wholly or in part,
15 be reasonably chargeable to operating expenses or to income.

16 7. The financing with the conditions approved herein will not impair the financial status
17 of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair
18 the ability of the public utility to provide safe, reasonable and adequate service.

19 **ORDER**

20 IT IS THEREFORE ORDERED that the application for financing, with the conditions
21 contained herein, is hereby approved and Arizona Public Service Company is hereby authorized to
22 either issue non-secured debt in an amount not greater than \$500,000,000 and/or guarantee the debt
23 of Pinnacle West Energy Corporation in the amount of \$500,000,000, for the purposes set forth in the
24 application and as modified herein, and in compliance with the conditions and restrictions contained
25 in the discussion and findings herein.

26 IT IS FURTHER ORDERED that such debt will not be classified or treated as continuing
27 debt in the context of the debt limits established by Decision Nos. 55017 and 54230.

28 IT IS FURTHER ORDERED that Arizona Public Service Company is hereby authorized to

1 obtain a financial interest and/or a guarantee in its affiliate Pinnacle West Energy Corporation
2 consistent with the terms, conditions, and restrictions of this Decision.

3 IT IS FURTHER ORDERED that Arizona Public Service Company is hereby authorized to
4 engage in any transactions and to execute any document necessary to effectuate the authorization
5 granted herein.

6 IT IS FURTHER ORDERED that such authority is expressly contingent upon Arizona Public
7 Service Company's compliance with the conditions set forth herein and upon the use of the proceeds
8 for the purposes set forth in the application as modified herein.

9 IT IS FURTHER ORDERED that approval of the financing set forth herein does not
10 constitute or imply approval or disapproval by the Commission of any particular expenditure of the
11 proceeds derived thereby or any particular prior expenditure being refinanced for the purpose of
12 establishing just and reasonable rates.

13 IT IS FURTHER ORDERED that Arizona Public Service Company shall file with the
14 Commission copies of all executed financing documents setting forth the terms of the financing,
15 within 30 days of obtaining such financing.

16 IT IS FURTHER ORDERED that Arizona Public Service Company shall not use any
17 authority granted in this Decision to prejudice or adversely affect the implementation of the Track B
18 competitive solicitation process.

19 IT IS FURTHER ORDERED that the issue of APS acquisition of Pinnacle West Energy
20 Corporation generation assets and rate base treatment is not presently before us, and we make no
21 determination on those issues in this Decision.

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1 IT IS FURTHER ORDERED that Staff shall commence a preliminary investigation into
2 Arizona Public Service Company and its affiliate's compliance with the Electric Competition Rules,
3 Decision No. 61973, its Code of Conduct, and applicable law.

4 IT IS FURTHER ORDERED that this Decision shall be come effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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8 CHAIRMAN COMMISSIONER COMMISSIONER

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10 COMMISSIONER COMMISSIONER

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12 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
13 Secretary of the Arizona Corporation Commission. have
14 hereunto set my hand and caused the official seal of the
Commission to be affixed at the Capitol, in the City of Phoenix,
this ____ day of ____, 2003.

15
16 BRIAN C. McNEIL
EXECUTIVE SECRETARY

17 DISSENT _____

18 DISSENT _____
LAF:dap

1 SERVICE LIST FOR: ARIZONA PUBLIC SERVICE COMPANY
2 DOCKET NOS.: E-01345A-02-0707
3
4 Jeffrey B. Guldner
5 SNELL & WILMER
6 One Arizona Center
7 400 E. Van Buren
8 Phoenix, Arizona 85004
9
10 Thomas L. Mumaw
11 Karilee Ramaley
12 PINNACLE WEST CAPITAL CORP
13 LAW DEPARTMENT
14 P.O. Box 53999, MS 8695
15 Phoenix, Arizona 85004-3999
16
17 C. Webb Crockett
18 Jay L. Shapiro
19 FENNEMORE CRAIG
20 3003 N. Central Avenue, Suite 2600
21 Phoenix, Arizona 85012
22 Attorney for Panda Gila River, L.P.
23
24 Larry F. Eisenstat
25 Michael R. Engleman
26 Frederick D. Ochsenhirt
27 DICKSTEIN SHAPIRO MORIN &
28 OSHINSKY LLP
2101 L Street, NW
Washington, DC 20037
Attorneys for Panda Gila River, L.P.
Scott Wakefield
RUCO
1110 W. Washington, Suite 200
Phoenix, Arizona 85007
William P. Sullivan
Michael A. Curtis
2712 N. 7th Street
Phoenix, Arizona 85006-1090
Attorneys for Reliant Resources, Inc.

1 Roger K. Ferland
2 QUARLES & BRADY STREICH LANG, LLP
3 Renaissance One
4 Two North Central Avenue
5 Phoenix, Arizona 85004-2391
6 Attorneys for Harquahala Generating Company, LLC

7 Jay I. Moyes
8 MOYES STOREY
9 3003 N. Central Ave., Suite 1250
10 Phoenix, Arizona 85012
11 Attorneys for PPL Southwest Generation Holdings, LLC;
12 PPL Energy Plus, LLC; and PPL Sundance Energy, LLC

13 Jesse A. Dillon
14 PPL
15 2 North Ninth Street
16 Allentown, Pennsylvania 18101

17 Walter W. Meek
18 AUIA
19 2100 N. Central Ave., Suite 210
20 Phoenix, Arizona 85004

21 Lawrence V. Robertson, Jr.
22 MUNGER CHADWICK
23 National Bank Plaza
24 333 N. Wilmot, Suite 300
25 Tucson, Arizona 85711
26 Attorneys for Southwestern Power Group II, LLC; Bowie Power Station;
27 and Sempra Energy Resources

28 Greg Patterson
ACPA
5432 E. Avalon
Phoenix, Arizona 85018

Raymond S. Heyman
Michael W. Pattern
ROSHKA, HEYMAN & DeWULF
One Arizona Center
400 E. Van Buren, Suite 800
Phoenix, Arizona 85004
Attorneys for Tucson Electric Power Co.

1 Christopher Kempley, Chief Counsel
ARIZONA CORPORATION COMMISSION
Legal Division
2 1200 West Washington
Phoenix, AZ 85007
3

4 Ernest Johnson, Director
Utilities Division
ARIZONA CORPORATION COMMISSION
5 1200 West Washington Street
Phoenix, Arizona 85007
6

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9
10
11
12
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